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C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 006594

SIPDIS

TREASURY FOR INTERNATIONAL AFFAIRS - MMILLS AND RADKINS
NSC FOR BRYZA AND MCKIBBEN

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SUBJECT: IMF CAUTIOUSLY OPTIMISTIC THAT NEW PROGRAM CAN BE
AGREED BY MID-DECEMBER

REF: ANKARA 6426

Classified by DCM Robert S. Deutsch. Reasons 1.5 (b) and (d).

1. (C) Summary: A third and hopefully final IMF mission negotiating a new 3-year stand-by program will return to Turkey November 30 with hopes of concluding discussions before EU leaders meet December 17. The IMF's return follows what both the IMF and Turks view as substantial progress on Turkey's part (including in dropping a push for a VAT rate cut) since the second mission failed to reach agreement in October. The Fund's work has been more difficult than expected, and the Turks may still seek to use the December 17 meeting to leverage new concessions, such as on the size of IMF financing. End Summary.

Mission coming in hopes of a deal by mid-December

2. (SBU) The IMF announced November 24 the return of a "mission" November 30. According to the Fund's resident representative, IMF staff is cautiously optimistic of reaching broad agreement on a new program in a couple of weeks although, as was the case with several reviews under the current program, a few actions may remain to be taken after the mission departs before a Letter of Intent (LOI) can be signed. (The resrep did not rule out the possibility that a LOI could be signed by mid-December.) Although the resrep said the Fund does not feel any deadline pressure, Minister Babacan and other Turkish officials are keen to be able to announce agreement with the IMF before the EU Council decides on Turkey's application for EU membership on December 17.

Significant Progress on Outstanding Issues

3. (SBU) The resrep confirmed Turkish officials' comments (ref) that they have made significant progress on issues left open after the October mission:

--VAT rates: The GOT dropped its proposed broad rate cut, as well as narrower rate cuts for sensitive sectors. There may be some very minor changes but no significant rate cut.

--Tax Administration: The IMF believes the current draft of the tax law takes into account everything the Fund was looking for. For example, responsibility for tax policy would be in the Ministry of Finance rather than in the Tax Administration.

--Social Security Reform: While there is not yet unequivocal political commitment to either push back retirement ages or increase social security payroll taxes, IMF staff believes the progress the World Bank has made on the technical level supports a belief that agreement can be reached during the mission.

--Banking Law: Fund staff has not seen the latest draft from the bank regulatory agency (BRSA) which is in the process of being transmitted to Deputy Prime Minister Sener and the Prime Minister. The Resrep believes that Turkish Treasury will help get the GOT to overrule the BRSA's continued insistence that sworn bank auditors retain their monopoly of on-site inspection.

--2004 fiscal overperformance: The IMF and GOT are moving towards a solution, helped by the fact that special revenue receipts have been lower than the IMF and Turks had thought in October would be the case.

--State Banks: With the World Bank having begun to rethink this issue in October, the IMF may limit itself at the beginning of a program to "damage-limitation actions" rather than agreement on a comprehensive privatization strategy. For example, the program could initially include removing State Banks' privileges and constraining the use of their capital, with more far-reaching actions implemented over the course of the program.

Privatization and Asset Sales

14. (SBU) The resrep said the new program would likely not include enforceable privatization targets. The IMF is reluctant to make targets other than indicative ones given the ability of the courts to block privatizations. Fund staff will be closely monitoring progress in 2005, however, particularly regarding any GOT hesitancy to sell SEE's below an artificial "reserve price" The program will also include indicative targets on SDIF asset sales from intervened banks. SDIF has already proposed legislation indemnifying buyers of these assets from lawsuits.
Size of Facility

15. (SBU) Fund staff continues to believe the Turks will seek IMF financing greater than the parameters the Executive Board set before the first mission. Babacan reportedly did not raise the issue in his meeting with IMF Managing Director Rato on the margins of the G-20 meetings in Berlin. The resrep thinks Minister Babacan has taken to heart Fund staff advice that it would be better to wait until they are closer to agreement before the GOT weighs in with Fund management.
Comment

16. (C) The failure of a third mission would be unprecedented for Turkey and send a very negative signal to markets. Yet the Fund's work has been more difficult than either it or the Turks anticipated, and we are not yet at the end of the road. The Fund's difficulties demonstrate the lack of high-level political will on difficult but unavoidable structural reforms, even in what would seem to be a conducive macro environment (GDP growth double initial forecasts and lower than expected inflation and unemployment rates.) While Babacan and the technocrats feel a need to announce agreement before the EU meeting, we do not exclude a last minute Turkish push for new IMF concessions -- such as on the size of the financing -- that would seek to leverage a December 17 "deadline."
EDELMAN